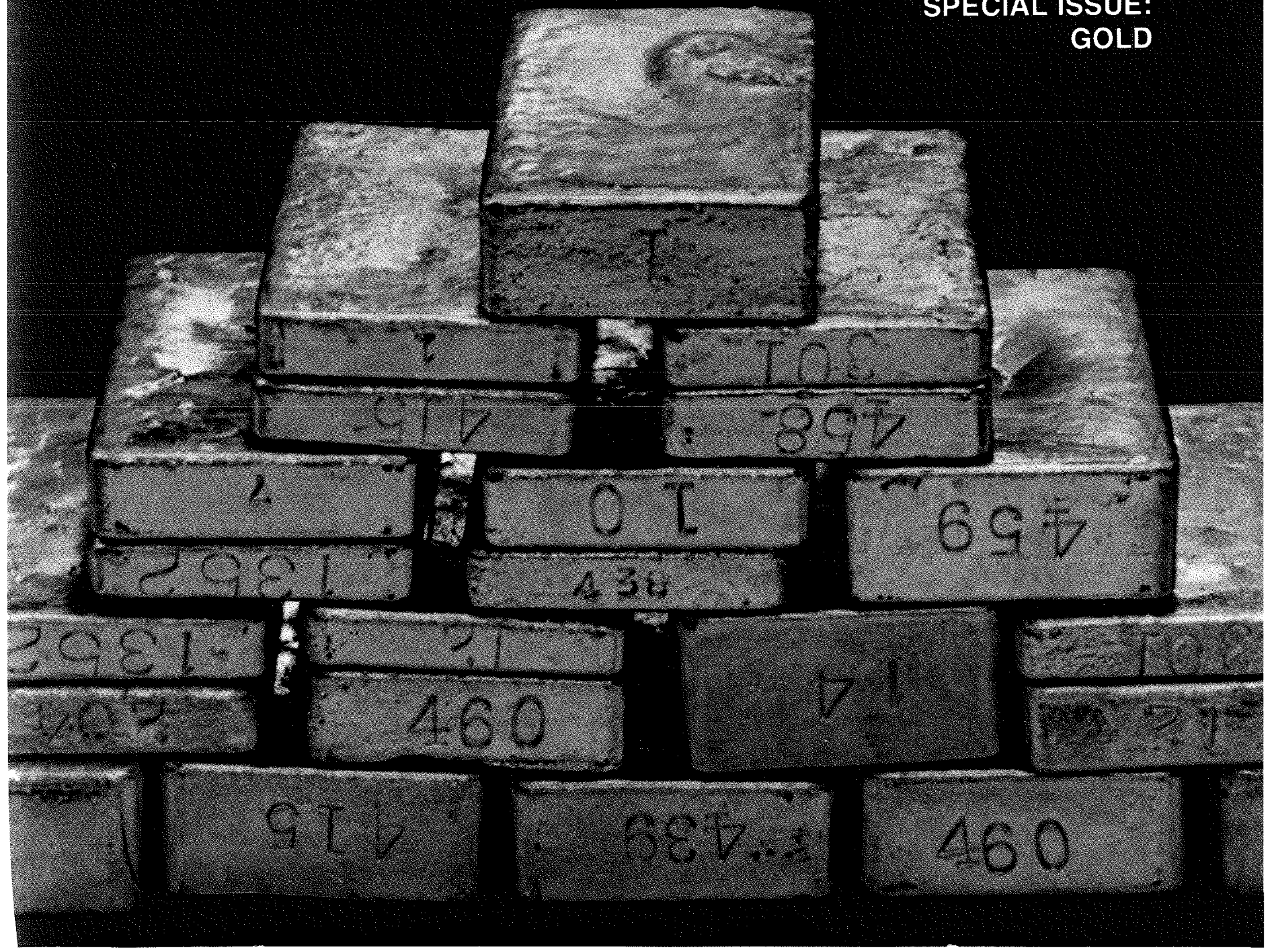
BUSINESS REVIEW

WINTER 1974-75

FEDERAL RESERVE BANK OF SAN FRANCISCO

SPECIAL ISSUE: GOLD



Gold: End of an Era?

"Gold is a wonderful clearer of the understanding," wrote Thomas Addison in a 1711 issue of the *Spectator*, yet many misconceptions have grown up around the lustrous metal during the intervening centuries. In an attempt to clarify the situation as it stands in the mid-1970's, this special issue of the *Review* presents three analytical articles written against the background of recent far-reaching changes in U.S. gold policy. Within a brief half-decade, we have witnessed the creation of the two-tier gold market, two devaluations of the dollar, and now in 1975, the lifting of the longstanding ban on the private ownership of gold, followed by the auctioning of a small portion of the nation's gold stock.

In the first article, Hang-Sheng Cheng and Nicholas P. Sargen place these recent events in historical perspective, before analyzing the reasons for the U.S. Government's decision to end the monetary role of gold. They consider several traditional arguments advanced by advocates of gold—for example, the need for the "discipline" of the gold standard to set prescribed automatic limits to the power of the nation's monetary authorities. But they note that the world economy in the heyday of the gold standard did not benefit from such discipline, but instead was characterized by wide fluctuations in both output and prices. Again, gold supposedly has provided a safer asset than national currencies—but in their view, this argument puts the cart before the horse. It was the official support of the price of gold that sustained its value, and not the reverse.

In accounting for the recent shift in U.S. policy, Cheng and Sargen point to an element of instability in the Bretton Woods gold-dollar standard after World War II, because of an asymmetry in its exchange-rate adjustment mechanism. Any other country could change a "fundamental disequilibrium" in its balance of payments by altering the exchange rate of its currency against the U.S. dollar—but the United States, with its currency pegged to gold, was poorly situated to change its exchange rate. This asymmetrical situation was compounded by a devaluation bias in exchange-rate adjustments, which permitted surplus countries to postpone or avoid revaluation, while deficit countries were forced to devalue by their weakening reserve positions. Consequently, when the U.S. allowed its domestic inflation rate to get out of hand in the late 1960's, the dollar became increasingly overvalued, and this resulted in massive accumulations of dollars in foreign official holdings, as well as a decline in the competitive position of American manufacturers in foreign and domestic markets.

In the meantime, Special Drawing Rights (SDRs) developed as a major new reserve asset, providing a superior alternative to gold. Unlike gold, they earn interest, cost nothing to produce and store, and provide means for an internationally controlled growth of world liquidity.

Looking toward the future, Cheng and Sargen note the existence of 1.2 billion ounces of gold in official holdings—and perhaps 2.5 billion ounces in private holdings—and they ask what may happen to these stocks in the wake of the U.S. decision to demonetize gold. Their conclusion is that the prospects for a resurrection of gold are rather dim. Unless a new "gold-center country" emerges to buy and sell gold at some official price, gold may join silver as just another historical relic. They even suggest the possibility of governments selling off their stocks. In that event, an international agreement might be necessary to maintain the value of official gold holdings, in order to preserve the value of national savings already embodied in such assets.

In the second article, Kurt Dew contrasts the 1968-75 shift in U.S. gold policy with the policy of the 1930's, when the Administration prohibited private gold holdings and tried to push up gold prices as a means of supporting farm prices. He asks several questions about these quite dissimilar episodes: Did the policies achieve their intended results? Did external actions offset the intended beneficial effects? Did gold help in either case to advance the nation's economic welfare?

Dew argues that the policy of the 1930's achieved its intended effect, but that it was a Pyrrhic victory, in view of the severe problems caused in the European gold-bloc countries by the vast outflow of gold to the United States. A fundamental policy flaw in that period was the tendency of both this country and the gold-bloc nations to follow gold policies rather than expansionary monetary policies.

Turning to the current situation, Dew says that U.S. policy has achieved its intended effect by relegating gold to the same status as that of any other commodity. He considers several factors that could offset the benefits of this policy, but argues that each of these possibilities is rather remote. For example, small individual investors and large institutional investors could both create problems for the economy by switching their assets into gold, but they are not likely to have much incentive to do so. Also, foreign and domestic financial authorities will probably not repeat the perverse policy errors of the 1930's, but will instead continue on their present path of monetary cooperation.

In the third article, Michael W. Keran and Michael Penzer examine the role of gold as a private hedge against inflation. They note that the timing of gold purchases is crucial; naturally, the investor would have profited considerably if he had bought in 1968 and sold in 1975, but he would have lost half of his purchasing power if he had instead bought in 1934 and sold in 1968. Next they examine the possible return on alternative investments, such as other commodities, foreign currencies and interest-bearing financial assets. These investments at times have provided better returns than gold—and without the accompanying problems, such as the illiquidity of gold investment and the large variance of gold prices.

Keran and Penzer then evaluate gold's future in terms of the supply and demand factors that have led to the sharp price upsurge of the 1970's. On the supply side, they note the 20-percent decline in flow that occurred in the past four years, largely because of the production problems of the dominant producer, South Africa—but they contend that recent peak prices should lead to production increases in the longer run. Also, they argue that downward price pressures could arise from the massive stocks over-hanging the market; central-bank holdings alone are more than 25 times larger than current production.

On the demand side, Keran and Penzer note the existence of a flow demand for industrial, commercial and artistic purposes, as well as a stock demand for inventory building by central banks and private investors and speculators. Flow demand could decline because of the recession and because of the very high price of gold. Stock demand could weaken on the part of central banks, reflecting the continued efforts to demonetize gold, and it could also weaken for investors and speculators, to the extent that inflationary expectations are somehow kept in check. Thus, they conclude: *caveat emptor*. Despite gold's excellent record as an investment in the last several years, the remainder of the decade will inevitably bring changes in the supply and demand factors governing the price of gold—changes which could easily shift the price trend downward.